SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1965

NO.

PIZITZ, INC., Successor to LOUIS PIZITZ DRY GOODS COMPANY,

Petitioner

vs.

GEORGE D. PATTERSON, DISTRICT DIRECTOR OF INTERNAL REVENUE, BIRMINGHAM, ALABAMA,

Respondent

TO THE HONORABLE CHIEF JUSTICE AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Your Petitioner, Pizitz, Inc., respectfully prays for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit to review a judgment entered December 1, 1965, reversing judgment of the United States District Court for the Northern District of Alabama and remanding the case to the said District Court for entry of judgment for Respondent.

a. Opinions of Courts Below

The opinion of the United States Court of Appeals for the Fifth Circuit has not yet been reported. It is appended hereto as Exhibit "A". The judgment in the District Court was entered on the jury's verdict, and no opinion was rendered.

b. Jurisdiction

Jurisdiction of this Court to review the judgment in question by Writ of Certiorari is conferred by the United States Code 1958 ed., Title 28, Section 1340. The date of the judgment sought to be reviewed is December 1, 1965. A true copy of this judgment is appended hereto as Exhibit "B".

c. Question Presented

Does the Seventh Amendment preclude redetermination by the Court of Appeals of a jury's findings of fact of the amount of a deduction for a reasonable addition to a reserve for bad debts, and of an abuse of discretion on the part of Commissioner of Internal Revenue in disallowing this deduction?

d. Constitutional Provisions and Statutes

Amendment VII, Constitution of the United States, ratified December 15, 1791:

> "In suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise reexamined in any Court of the United States, than according to the rules of the common law."

Internal Revenue Code of 1954:

> SEC. 166. BAD DEBTS
>
> (a) General Rule.
>
> (1) Wholly worthless debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.
>
> x x x
>
> (c) Reserve for Bad Debts.—In lieu of any deduction under subsection (a), there shall be allowed

(in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts."

26 U.S.C. 1958 ed., Sec. 166.

e. Statement of the Case

The petition for writ of certiorari is to review judgment of the United States Court of Appeals for the Fifth Circuit, reversing judgment for the taxpayer entered on a jury's verdict and remanding the case for entry of judgment in favor of the District Director of Internal Revenue. The basis of federal jurisdiction below is Title 28, United States Code 1958 ed., Section 1340.

The taxpayer is a corporation operating a department store in downtown Birmingham, Alabama. The reserve method for computing deduction for bad debts under Section 166 (c) of the Internal Revenue Code was used by taxpayer and the amount of the reserve was based on adding an amount annually to the existing reserve after charging bad debt losses so that the total reserve at the end of the year equaled 6% of the outstanding accounts payable.

The deduction at issue was in the amount of $65,694.53 for an addition to reserve for the fiscal year ending January 31, 1960. The Commissioner disallowed the entire deduction on the theory that the reserve in the amount of $173,295.81 on hand at the end of the fiscal year was ample. This figure represented the bad debt reserve at January 31, 1959, of $237,331.81 less net charge-offs during the year of $64,036.

The following tabulation demonstrates the bad debt losses for the five year period ending with the fiscal year in question.

Year Ended	Accounts Receivable	Charged Off	Recovered	Net Loss
1/31/56	$ 3,914,148	$109,791	$ 17,362	$ 92,429
1/31/57	4,063,881	112,571	26,419	86,152
1/31/58	4,046,782	108,925	39,004	69,921
1/31/59	3,958,084	101,843	43,622	58,221
1/31/60	3,984,986	100,565	36,529	64,036
Totals	$19,967,881	$533,695	$162,936	$370,759

Taxpayer's established reserve for bad debts was in the amount of six percent of its accounts receivable. This reserve had been agreed to with the Internal Revenue Service during the year 1955 and had been used by taxpayer without change for all subsequent years and approved by the Internal Revenue Service after audit for said years. The Commissioner had approved the reserve of $237,331.81 as of the close of the year 1959. The addition to the reserve, here in question, merely enabled taxpayer to maintain the reserve approved by the Commissioner as reasonable as of the beginning of the year.

The average of the reserve for bad debts during the period 1956 to 1960 was $237,903.00. The difference between the January 31, 1960, reserve and the average for the said five years was approximately only $1,000.00.

Shortly prior to beginning of taxpayer's fiscal year ending January 31, 1960, specifically in December 1958, taxpayer changed its credit policy. Beginning in August 1954 taxpayer used three types of accounts with different credit terms. One was the basic 30-day account which was due the 10th of the month following the billing. A second type was installment credit with terms depending on the merchandise, six months or 24 months. The third type was the revolving credit, or Pay Buy account, which al-

lowed the customers to charge six times their credit limit. In December 1958 the revolving credit was extended to allow a customer to owe at any time ten times the monthly credit limit. In other words, on a $25.00 credit limit the customer, beginning in December 1958, could owe at one time $250.00 rather than $150.00. Payments on the Pay Buy accounts beginning in 1956 constantly increased in delinquency. In the 120-day delinquency classification these accounts receivable percentages were 3.43% in 1956, 7.24% in 1957, 9.86% in 1958, 7.49% in 1959, 8.53% in 1960, 9.74% in 1961, 10.27% in 1962, 11.12% in 1963.

Collection percentages of the monthly balances also constantly went down during the period, from 30.31% in 1958, 20.09% in 1959, 20.11% in 1960, 18.91% in 1961, 17.91% in 1962, and 17.79% in 1963.

There was an increase in Pay Buy accounts to total accounts receivable throughout this period. Beginning in 1956 Pay Buy accounts amounted to 14%, in 1957 to 21%, 1958 to 25%, 1959 to 28%, 1960 to 32%, 1961 to 37%, 1962 to 47%.

Taxpayer incurred legal expenses in recovery of bad debts amounting to approximately one-third of the recovery, which were charged as operating expenses and not to the recovery. If legal expenses had been charged to the recovered amount, it would have reduced recoveries by approximately one-third, or in the year ending January 31, 1960, recoveries of $36,529.00 would have been reduced approximately $12,000.00. In other words, of approximately $162,000.00 recoveries during the period, some $55,000.00 would have been legal expenses not charged to reserve but charged as an expense.

The certified public accountant witness on government cross-examination testified that based on accounts receivable of $4,000,000, a $240,000.00 reserve was necessary.

On cross-examination he also testified that the six percent figure was determined by the government, and that taxpayer had used a higher figure based on present, past and future conditions. That retail firms did not base reserve additions entirely on past experience. That this six percent figure had been determined by the government in letter dated September 14, 1956. Formerly taxpayer had taken a deduction for addition to bad debt reserve based on 7½% for open accounts and 10% on budget accounts.

Economic conditions in downtown City of Birmingham, where taxpayer's main business is, started going down in 1959 and have been going down since that time. Birmingham is basically a steel and mining town. Taxpayer's president testified that he had to take into consideration past experience, particularly in depression days in Birmingham when losses were phenomenal, having approximately $4,000,000 owed to taxpayer on long-term payments in an industrial town where most of the coal mines except the captive coal mines had been shut down. Taxpayer had extended in 1959 credit to individuals who were on strike, which also fluctuated taxpayer's customer market. The labor and economic conditions in Birmingham forseeably affected taxpayer's ability to collect its accounts because when people were not working or were laid off, or there was more automation, as happened in Birmingham in 1958 and 1959, its customers had the inability to pay.

Economic conditions in Birmingham during the year 1959 prior to January 31, 1960, are generally set forth in the government's Exhibit #2, as follows:

> "In June of 1957 a peak employment of 210,850 was reached after which a general softening of the economy began. Employment dropped in 1958 to average 197,800 as the full impact of the softening trend was felt. Recovery was begun during the latter months of

1958 and early in 1959, but another major labor dispute which began in July and lasted into November forced the 1959 annual average downward to register 196,600."

Judgment in the District Court was entered in accordance with special findings and verdict of the jury as follows:

"1. Do you find from a preponderance of the evidence that the Commissioner of Internal Revenue abused his discretion in refusing to allow Pizitz, Inc., a deduction for an addition to its reserve for bad debts for its fiscal year which ended January 31, 1960? Indicate your verdict by checking the appropriate answer below:

Yes x No ____

"2. If your answer to Interrogatory No. 1 is yes, indicate in dollars the amount which you find to be a reasonable addition to the reserve for bad debts of Pizitz, Inc., for its fiscal year ending January 31, 1960.

$65,694.53."

f. Reasons Relied on for Allowance of Writ

The decision below presents a constitutional question of major importance in the administration of justice. The Court of Appeals has reexamined and redetermined facts found by a jury contrary to the intent and spirit of the Seventh Amendment.

Mr. Justice Douglas in a recent opinion for the Court has stated:

"We might agree with the Court of Appeals had the questions of fact been left to us. But neither we nor the Court of Appeals can redetermine facts found by the jury any more than the District Court can predetermine them. For the Seventh Amendment says that 'no fact tried by a jury, shall be otherwise reex-

amined in any Court of the United States, than according to the rules of the common law.' "

Atlantic & Gulf Stevedores, Inc. v. Ellerman Lines, 369 U.S. 355, 358, 359; 82 S.Ct. 780, 783

Right of trial by jury ranks high in the catalogue of constitutional safeguards. This Court has referred to this right in the following language:

"The right of jury trial in civil cases at common law is a basic and fundamental feature of our system of federal jurisprudence which is protected by the Seventh Amendment. A right so fundamental and sacred to the citizen, whether guaranteed by the Constitution or provided by statute, should be jealously guarded by the courts."

Jacob v. City of New York, 315 U.S. 752, 753, 62 S.Ct. 854

The jury found that a reasonable addition to taxpayer's reserve for bad debts for its fiscal year ending January 31, 1960, was $65,694.53 and that the Commissioner of Internal Revenue abused his discretion in refusing to allow taxpayer a deduction therefor.

The jury could have reached these conclusions from the fact that the Commissioner had allowed and accepted a bad debt reserve of $237,332.00 at January 31, 1959, and as of January 31, 1960 determined a reserve of only $173,295.81 to be reasonable, where accounts receivable increased during the year over $25,000, where the actual bad debt chargeoffs approximately equaled the reserve addition deducted, where the evidence showed that economic conditions in downtown Birmingham started going down, and that taxpayer had put into effect a new revolving installment credit policy permitting customers to charge

ten times their monthly credit limit rather than six times and further showed a steady increase in delinquent accounts receivable percentage and a steady decrease in collection percentages of monthly balances. The jury could have so concluded from the fact that the labor and economic condition of the Birmingham area, basically steel and mining, which had suffered so disastrously from the depression of the early 1930's, was such that a bad debt reserve of six percent of accounts receivable, where the accounts amounted to approximately $4,000,000, was reasonable. The Court of Appeals recognized that taxpayer's evidence was "strong factually", stating at page 6 of its opinion:

> "The proof here showed only that the Commissioner, in effect, reduced the reserve to accord with taxpayer's loss experience in the light of existing circumstances bearing on credit losses. There are, of course, strong factually based arguments against his judgment in so doing but they fall short of establishing arbitrariness."

It is submitted that the fact that the taxpayer's bad debt experience over the five preceding years was less than six percent is only a formula factor to be considered and not one to be slavishly adhered to, particularly when the conclusion therefrom is contrary to the jury's verdict. The applicable rule of law is:

> "The jury having made that inference, the respondents were not free to relitigate the factual dispute in a reviewing court. Under these circumstances it would be an undue invasion of the jury's historic function for an appellate court to weigh the conflicting evidence, judge the credibility of witnesses and arrive at a conclusion opposite from the one reached by the jury."

x x x

"Only when there is a complete absence of probative facts to support the conclusion reached does a reversible error appear."

Lavender v. Kurn,
327 U.S. 645, 652, 653,
66 S.Ct. 740, 744

Nor is the exercise of discretion by the Commissioner of Internal Revenue "sacrosanct" in character and effect.

Blair v. Oesterlein Machinery Co.,
275 U.S. 220, 227, 48 S.Ct. 87, 89

The conflict between the Constitution and the decision of the Court of Appeals should be resolved by this Honorable Court.

WHEREFORE, your Petitioner respectfully prays that a Writ of Certiorari be issued under the seal of this Court directed to the United States Court of Appeals for the Fifth Circuit, to the end that this case may be reviewed and determined by this Court and that the judgment of the United States Court of Appeals for the Fifth Circuit entered in the case below be reversed and the jury's verdict upheld.

WILLIAM S. PRITCHARD

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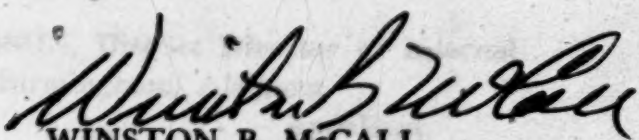
PRITCHARD, McCALL & JONES
Of Counsel

PROOF OF SERVICE

I, Winston B. McCall, one of the attorneys for Pizitz, Inc., Petitioner herein, and a member of the bar of the Supreme Court of the United States, hereby certify that on the 7th day of January 1966 I served copies of the foregoing petition for writ of certiorari on the Respondent by mailing three copies in a duly addressed envelope, with air mail postage prepaid, to The Solicitor General, Department of Justice, Washington 25, D. C.



WINSTON B. McCALL
Counsel for Petitioner

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 21951

GEORGE D. PATTERSON, District Director of Internal Revenue, Birmingham, Alabama,

Appellant,

versus

PIZITZ, INC., Successor to Louis Pizitz Dry Goods Company,

Appellee.

Appeal from the United States District Court for the Northern District of Alabama.

(December 1, 1965.)

Before MARIS,* RIVES, and BELL, Circuit Judges.

BELL, Circuit Judge: This is an appeal from a judgment for the taxpayer entered on a jury verdict. The taxpayer is a corporation operating a department store in Birmingham, Alabama. The reserve method for computing deductions for bad debts under Section 166(c) of the Internal

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* Of the Third Circuit, sitting by designation.

Revenue Code of 1954 was used. 26 USCA, Section 166(c).[1] The reserve for bad debts was based on adding an amount annually to the existing reserve so that the total reserve at the end of the year equaled six per cent of the outstanding accounts receivable. The addition which was made after charging bad debt losses taken during the year to the existing reserve is what is claimed as a deduction on the income tax return.

The deduction in issue here is in the amount of $65,694.53 for an addition to reserve for the fiscal year ending January 31, 1960. The Commissioner disallowed the entire deduction on the theory that the reserve in the amount of $173,295.81 on hand at the end of the fiscal year was ample. This figure represented the bad debt reserve at January 31, 1959 of $237,331.81 less net charge offs during the year of $64,036.00.

The applicable principle of law was stated by the Tax Court in *Krim-Ko Corp. v. Commissioner*, 16 T.C. 31 (1951) at 37:

> ". . . [T]he crux of the matter is not whether the additions to the reserve are sufficient to absorb the bad debts that might arise during the years involved. Rather, the question is whether the reserve itself was sufficient for that purpose. And if the Commissioner was justified in concluding, in the light of prevailing conditions, that

[1] 26 USCA, § 166(c):
"In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate), a deduction for a reasonable addition to a reserve for bad debts."

> the reserve already on the taxpayer's books was adequate, we cannot overturn his exercise of discretion to disallow further additions to the reserve."

See also *Roanoke Vending Exchange, Inc. v. Commissioner*, 40 T.C. 735 (1963) at 740-741; and *Platt Trailer Co. v. Commissioner*, 23 T.C. 1065 (1955) at 1070.

Generally stated it appeared from the evidence tending to support the Commissioner that he allowed taxpayer to use the six per cent formula beginning with the fiscal year ending in 1956. Theretofore taxpayer had used a basis of reserving seven and one half per cent of open accounts receivable and ten per cent of revolving or long term accounts receivable. The reserve at the end of the fiscal year 1956 was $232,576.00. The following chart demonstrates the bad debt losses for the five year period ending with the fiscal year in question.

Year Ended	Accounts Receivable	Charged Off	Recovered	Net Loss
1/31/56	$ 3,914,148	$109,791	$ 17,362	$ 92,429
1/31/57	4,063,881	112,571	26,419	86,152
1/31/58	4,046,782	108,925	39,004	69,921
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1/31/60	3,984,986	100,565	36,529	64,036
Totals	$19,967,881	$533,695	$162,936	$370,759

Thus it appears that the accounts receivable averaged approximately $4,000,000.00 annually and that the bad

debt loss averaged $74,000.00 or just under two per cent. The loss amounted to 2.3 per cent for 1956, 2.12 per cent for 1957, 1.73 per cent for 1958, 1.47 per cent for 1959 and 1.6 per cent for 1960. The reserve at the end of fiscal year 1960 in the amount of $173,295.81 was 4.3 per cent of the accounts receivable.

The taxpayer sued for refund after having paid the tax due following the disallowance of the deduction. The District Court submitted the question of whether the Commissioner abused his discretion in refusing to allow the deduction to a jury which answered in the affirmative. The motion of the Director for a directed verdict was denied as was his motion for judgment notwithstanding the verdict. Rule 50, F.R.Civ.P. This appeal followed the denial of the latter motion.

The question presented is whether the evidence and the inferences adduced therefrom, when viewed in a light most favorable to the taxpayer, justified submitting the case to the jury on the issue of abuse of discretion on the part of the Commissioner in the premises. *Swift & Company v. Morgan & Sturdivant*, 5 Cir., 1954, 214 F.2d 115. See also *United States v. Byck*, 5 Cir., 1963, 325 F.2d 551; and *Hogan v. United States*, 5 Cir., 1963, 325 F.2d 276.

We begin then with the fact that the amount of the receivables and the bad debt losses remained relatively stable or constant throughout the five year period of 1956-1960, and that the bad debt reserve as of the end of the 1960 fiscal year was more than twice what might be anticipated by way of bad debt losses based on the experience during

the five year period. As against this the taxpayer offered the following evidence to show the requisite abuse. The testimony of its accountant was that a reserve of six per cent of accounts receivable was necessary, and that the Commissioner had allowed the use of the six per cent formula as described throughout the period of five years. There was evidence that delinquencies were increasing as were the type of accounts which were more susceptible to becoming delinquent. There was proof that recoveries on charge offs would have been decreased had legal expenses incurred in the process of recovery been deducted from the recoveries rather than as a general operating expense. This would have resulted in a decrease in the reserves on hand of approximately $12,000.00 at the end of fiscal 1960, or $55,000.00 during the five year period. There was some evidence that economic conditions in the Birmingham area were on the down grade beginning in 1957. Automation was a problem and the work force in the area had decreased from a high of 210,850 in June of 1957 to an average of 196,600 for 1959. Strikes were also a problem. Moreover, taxpayer relied on the fact that its credit policy was liberalized in 1958 but subsequent experience did not support its contention that substantially more losses would result.

Considering the evidence on balance, we find that it does not rise to that level of proof which would show an abuse of discretion on the part of the Commissioner. In *Maverick-Clarke Litho Co. v. Commissioner*, 5 Cir., 1950, 180 F.2d 587, 592 we said:

> "The Commissioner, under the applicable statute, was vested with a discretion in determining

what constituted a reasonable addition to a reserve for bad debts and his determination is entitled to more than a mere presumption of correctness. The burden was on petitioner to show that the Commissioner abused his discretion and its proof falls far short of meeting that heavy burden."

We there relied on *United States v. Beckman*, 3 Cir., 1939, 104 F.2d 260 where the court equated abuse of discretion by the Commissioner with arbitrariness. See also *Lucas v. Kansas City Structural Steel Co.*, 1930, 281 U.S. 264, 50 S.Ct. 263, 74 L.Ed. 848; and Mertens, Law of Federal Income Taxation, Vol. t, § 30.74.

The proof here showed only that the Commissioner, in effect, reduced the reserve to accord with taxpayer's loss experience in the light of existing circumstances bearing on credit losses. There are, of course, strong factually based arguments against his judgment in so doing but they fall short of establishing arbitrariness.

It follows that the District Court erred in failing to grant the motion of the Director for judgment notwithstanding the verdict. The case is reversed and remanded for entry of judgment for the Director.

REVERSED and REMANDED with direction.

Adm. Office, U. S. Courts—E. S. Upton Printing Co., N. O., La.

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

October Term, 1965

No. 21951

D.C. Docket No. 63-373-Civil Action

GEORGE D. PATTERSON, District Director of Internal Revenue, Birmingham, Alabama,

Appellant,

versus

PIZITZ, INC., Successor to Louis Pizitz Dry Goods Company,

Appellee.

Appeal from the United States District Court for the Northern District of Alabama.

Before MARIS,* RIVES, and BELL, Circuit Judges.

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Alabama, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is

EXHIBIT "B"

hereby, reversed; and that this cause be, and it is hereby remanded to the said District Court for entry of judgment for the Director, in accordance with the opinion of this Court;

It is further ordered and adjudged that the appellee, Pizitz, Inc., Successor to Louis Pizitz Dry Goods Company, be condemned to pay the costs of this cause in this Court for which execution may be issued out of the said District Court.

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*Of the Third Circuit, sitting by designation.

December 1, 1965

Issued as Mandate: